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SENSITIVE
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TREASURY FOR M.NUGENT, T.RAND AND L. QUINN
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TOKYO FOR R. KAPROTH

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SUBJECT: INDONESIA'S GROWTH SLOWDOWN, BALANCE OF PAYMENT PRESSURES

REFS: (A) Jakarta 91 (B) Jakarta 311

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¶1. (SBU) Summary: Indonesia's economic growth is slowing as the global economic downturn has become more entrenched. Market consensus expects a growth slowdown (current IMF forecast is 3.5 percent), rather than recession, for 2009. The macroeconomic situation remains broadly stable, though pressure on the balance of payments (BOP), through the capital account, is viewed as the central risk to the economy given relatively modest foreign exchange reserves and uncertainty about the size of foreign currency debt in the corporate sector maturing in 2009. Analysts are also concerned about an increase in non-performing loans in Indonesian banks, given the deteriorating economic environment. Officials described their efforts to line up fiscal support through the contingency financing package led by the World Bank (with contributions from the ADB, Japan and Australia) and balance of payments support through the Chiang Mai Initiative currency swap lines. Although most interlocutors recognized the limits of a proposed World Bank-led contingency financing package to help Indonesia weather a balance of payments crisis, they stressed that the Indonesia government would not seek assistance from the International Monetary Fund in this election year. End summary.

¶2. (SBU) Treasury Director for South and Southeast Asia Malachy Nugent, Regional Financial Attache Susan Baker and econoff met with officials from the Indonesian Finance Ministry, Bank Indonesia (BI), IMF, World Bank and the private sector on February 18-19 to discuss Indonesia's current economic performance and the outlook for 2009 and to assess three areas of potential vulnerability: BOP, financial and fiscal.

Economic Growth Down, But Better than Most, With Risks
To Balance of Payments
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¶3. (SBU) Effects from the continued global economic downturn are visible in slowing domestic demand, sharply lower trade and declining bank lending. Local IFI officials and market observers believe Indonesia is most likely to experience a growth slowdown, rather than a more serious economic downturn, in 2009. In the current global environment, forecast economic growth of 3.5 percent

may be enough for Indonesia to record the third highest growth in the G-20, following China and India, as a number of analysts are predicting. Whether Indonesia will be able to maintain sufficient domestic demand to support 3.5 percent growth remains uncertain. Authorities have pursued monetary and fiscal expansion to support domestic demand, but difficulties in implementing rapid spending and continued currency weakness may limit the effectiveness of these policies. Ministry officials expressed disappointment that political opposition had prevented extension of the most effective form of fiscal stimulus - direct cash payments to targeted poor families - beyond February.

¶4. (SBU) IFI and Finance Ministry officials briefed that a lack of confidence continues to hamper capital markets. None of the officials or analysts consulted believed that Indonesia faces a BOP crisis now. However, most cited pressure on the BOP, through the capital account, as the central risk facing Indonesia. Of particular concern are relatively large private-sector foreign-currency loan repayments due in 2009. While the full extent of these repayments is uncertain, Bank Indonesia officials estimated them at USD 17.4 billion, with an estimated 30 percent involving loans from parent or affiliated companies and another 50 percent involving foreign borrowings by foreign companies that may have greater access to credit lines and refinancing.

¶5. (SBU) The IMF res rep said he does not see risks in the current account or the trade account, arguing that most imports are capital goods and raw materials that respond quickly to reduced demand. While Indonesia has lost important terms of trade gains made during the commodities boom, contacts believed that most producers in key

sectors such as crude palm oil and coal remain profitable. A knowledgeable private-sector analyst expects the trade balance to be in modest surplus (about USD one billion per month) in 2009.

¶6. (SBU) Nugent and Baker briefed Finance Ministry officials on recent USG actions in response to the economic slowdown, including the fiscal stimulus package and initiatives to improve credit market liquidity and deal with troubled assets on bank balance sheets. GOI officials urged the USG to provide additional information on these initiatives at the upcoming G-20 meeting in London, particularly for the benefit of those members outside the G-7. They expressed some concern about the risk that emerging markets will be crowded out of capital markets given increased U.S. and other developed country borrowing.

Rupiah Weakness A Constraint on Further Monetary Easing;
Bilateral Currency Swaps Helpful, But Not Enough
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¶7. (SBU) Indonesia remains vulnerable to capital flight and changes in sentiment by both foreign investors and, to a greater degree, by Indonesians. Interlocutors disagreed about the extent of the risk of further capital flight, but most agreed that reduced capital inflows have left BI as the only major supplier of foreign currency. Given its relatively modest foreign exchange reserves, market participants have questioned BI's ability to support the currency, although BI has reportedly stepped up intervention in recent weeks to prevent the rupiah from exceeding IDR 12,000/USD. At best, BI is likely to be able to dampen short term rupiah volatility, but not alter the underlying trend. The IMF res rep believes BI will continue to allow the rupiah to depreciate gradually. Several market observers also view continued rupiah weakness as a significant limitation on BI's ability to ease monetary policy further. BI officials advised that they see the overnight policy rate in the 7 to 8 percent range as inflation continues trending down. Private-sector analysts note that the current round of monetary easing has been relatively less effective at supporting economic growth due to banks' current reluctance to expand credit. Indonesian bank credit growth was one of the highest in the region in 2008 at 30 percent. BI officials hope that banks will continue to growth their loans in 2009, although at a more moderate rate of 15 to 18 percent expansion.

¶8. (SBU) BI officials briefed on plans to increase bilateral

currency swaps under the ASEAN plus 3 Chiang Mai Initiative (CMI) and reiterated Indonesia's interest in exploring similar swap facility arrangements with the U.S. Federal Reserve to provide a further cushion for the BOP. Private-sector analysts noted that the conclusion of enhanced bilateral swap arrangements through the CMI, while helpful, provides limited additional resources, since Indonesia can only access up to 20 percent of the swap lines without an IMF program in place.

¶9. (SBU) Private-sector analysts commented that Indonesia's economic team had adopted a sound approach in maintaining macroeconomic stability. BI's November decision to require evidence of underlying transactions in the purchase of foreign exchange had reduced speculation in currency markets. The new foreign exchange rules also appear to have kept some funds from entering Indonesia and prompted some Indonesians to hold deposits in dollars, rather than rupiah. These analysts also believed that efforts to require exporters to obtain letters of credit from domestic banks (see Ref A) would put Indonesian companies at a competitive disadvantage. They also cited as an example of unhelpful protectionism proposed GOI initiatives that would require oil and gas companies operating here to make all Indonesia-related payments through banking accounts established with Indonesian national commercial banks.

The Financial Sector: Pressures Largely Manageable, But
New Financial System Safety Net Law Needed
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¶10. (SBU) BI officials expect non-performing loans levels to rise slightly (from 3.9 percent in December to 5 to 6 percent in 2009)

and capital adequacy ratios to decline slightly (from 16 percent to 14 percent), but pressures remain manageable. BI expects loan growth to fall from 30 percent in 2008 to 15-18 percent in 2009, and deposit growth to reach 10-12 percent. Dollar liquidity remains tight, while rupiah liquidity has eased, with many banks moving extra funds into BI certificates and government bonds. World Bank staff noted that while some banks had experienced derivative losses related mostly to commodity positions, they do not believe the amounts are large enough to pose a systemic risk. Private-sector analysts agreed that banks remain well capitalized, particularly the top 15 banks which hold more than 2/3 of all deposits. They confirmed there has been a migration of deposits to larger banks from smaller banks, some of which need to increase capital or merge with other institutions. Finance Ministry officials and World Bank officials agreed that while some companies (such as the Bakrie Group) were overexposed after borrowing heavily (primarily from foreign lenders in the case of Bakrie), most banks had remained fairly conservative and were now stepping up scrutiny of new lending.

¶11. (SBU) BI officials and private-sector analysts stressed the need for swift approval of the government's new revised draft Financial System Stability Net, following the legislature's rejection of the initial law in December. Without it, BI and the Finance Ministry have insufficient tools to manage a significant banking crisis.

Financing the Deficit: More Details About World Bank-led Contingent
Financing Proposal
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¶12. (SBU) World Bank officials told us the proposed financing package for Indonesia (subsequently approved March 3) is unique given its contingent nature and briefed on why they believe the government needs this instrument under current conditions. World Bank staff described the current macroeconomic context as sound and not in need of fundamental adjustment. Bank staff said the USD 2 billion Public Expenditure Support Facility (PESF) Development Policy Loan with Deferred Drawdown Option (DPL-DDO), augmented by USD 3.5 billion in contingency financing from the Asian Development Bank, Japan and Australia, will improve Indonesia's ability to finance its budget and maintain macroeconomic growth. Bank staff advise that the package is likely to be most successful if global and domestic liquidity improves, with the DPL-DDO providing the market with increased confidence in Indonesia's ability to meet its

financing needs, without need for any draw-down. The "insurance value" of the package had already calmed markets to some extent, in the view of Bank staff. Even if capital markets remain tight and Indonesia is unable to meet its capital market financing targets and draw from the facility, Bank officials view it as an important resource to maintain priority spending.

¶13. (SBU) Finance Ministry officials confirmed their intention is to go capital markets first, with a focus on domestic markets, to meet their financing needs, including a fiscal stimulus equal to 1.5 percent of GDP. MOF officials said they will seek access to the contingent financing facility only if capital markets are essentially closed. Continued macroeconomic stability is a prerequisite for access to the funding and the World Bank will consult with the IMF will on this issue. The Bank, other donors, and the GOI intend to meet quarterly to determine whether the GOI has been able to meet its quarterly financing plan at a reasonable cost. If there is a shortfall and conditions are met indicating that markets were effectively closed (i.e. financing available only at rates exceeding historical financing costs by a defined significant margin), the World Bank and the other development partners would cover the shortfall. MOF Debt Management officials advised that if there is a gap under their quarterly target, they would draw first on the ADB budget loan, to be disbursed on a quarterly basis, and then divide any remaining gap among other development partners. They advised the ADB Board would consider the loan during the second week of April. They also briefed on Japan's plans to provide a guarantee on an Indonesian yen-denominated Samurai bond (reported Ref B).

Domestic Bond Issuance Remains Strong, As GOI Poised to
Go to International Markets When Conditions Permit
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¶14. (SBU) Officials and private-sector analysts all agreed that Indonesia continues to have good access to domestic and foreign capital markets, and underscored Indonesia's successful tapping of domestic capital markets in early 2009 and preparations to re-enter global capital markets when conditions are favorable. Finance Ministry Debt Management officials noted a series of successful domestic auctions in January and February and the successful issuance of its first retail sukuk (Islamic bond) in February. Strong demand allowed the Ministry to triple its initial target and it raised IDR 5.556 trillion (USD 464.9 million). Prior preparations for a Global Medium-Term Notes (GMTN) issuance program will position the GOI to take advantage of market opportunities and issue up to USD 4 billion in 2009 and 2010. Officials also noted that unused 2008 budget funds of IDR 51 trillion (USD 4.7 billion) had helped keep the government's cash management position in good shape.

The Need To Improve GOI-IMF Relations
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¶15. (SBU) Interlocutors across the board stressed that the Indonesian government would not go to the International Monetary Fund for assistance in this election year. The IMF resident representative suggested that Indonesia might be more likely to consider coming to the Fund if the new IMF Short-term Lending Facility were converted into a contingent facility, rather than one that required immediate drawing. He said the G-20 and IMF Board are discussing this issue. Improving GOI-IMF relations is needed, as World Bank officials and other observers acknowledge that if a larger macroeconomic crisis develops, Indonesia would need to look to the IMF and/or try to secure additional currency swaps.

Asking for U.S. Support in the G-20 and Elsewhere
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¶16. (SBU) Finance Ministry officials urged the USG to support a capital increase for the ADB to help emerging economies manage the fallout of the global economic crisis. They requested USG support in the G-20, where Indonesia is co-leading Working Group IV on reform of multilateral development banks.

¶17. (U) U.S. Treasury Nugent and Baker cleared cable.

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